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CITATIONS

776875—48——1

In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 537

GLENSHAW GLASS COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 156a–165a)[1] is not reported. The per curiam opinion of the Circuit Court of Appeals (R. 167) has not yet been reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered October 21, 1947. (R. 168.) The petitioner for a writ of certiorari was filed January 17, 1948. The jurisdiction of this Court is

[1] Record references are to the separately bound printed "Appendix" filed with taxpayer's petition.

invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's decision that $67,000 was a reasonable salary allowance under Section 23 (a) (1) (A) of the Internal Revenue Code for the services of taxpayer's three officers and controlling stockholders during its fiscal year 1942.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 14–16.

STATEMENT

The facts found the Tax Court (R. 157a–161a) may be summarized as follows:

Since its incorporation in 1900 taxpayer has engaged in the manufacture of glass bottles and containers. It reports its income on the basis of fiscal years ending September 30. The three Meyer brothers—Samuel, George, and Albert—were associated with taxpayer for many years as its executive officers. During the taxable years,[2] Samuel was president, treasurer, general manager and sales manager; George was secretary, assistant treasurer, and assistant manager in charge of

[2] Only the fiscal year 1942 is involved in this appeal. The Tax Court overruled the Commissioner's determination *in toto* as to the fiscal year 1941, and in part as to the fiscal year 1942. (R. 163a–164a.) The Commissioner did not cross-appeal.

production; and Albert was in charge of engineering and designing. (R. 157a.) Taxpayer had 6,000 shares of stock outstanding, of which the Meyer family owned 3,432 shares, the Beck and Berner families respectively owned 1,437 and 958 shares, and the remaining 173 shares were owned by others. A voting trust formed in 1939 of which the three Meyer brothers were the voting trustees held 3,017 shares (about 51% of the total), of which 2,958 were owned by the Meyer family, 48 by one Murphy, and 11 by one Heinl. Murphy and Heinl were employees of taxpayer. The board of directors during 1941 consisted of the three Meyer brothers, Ruth Meyer (a sister), a member of the Beck family (who was related to Samuel Meyer's wife), a member of the Berner family, and Heinl. The board was the same during 1942, except that Murphy was elected in place of Ruth Meyer. (R. 158a, 162a.)

The Meyer brothers were eminently qualified to conduct the business, and under their progressive management taxpayer made a net profit in each of the twenty years ending with 1942. It had paid a dividend in each of those years except in 1934, and in the taxable years the dividends totaled 16% of the capital stock. The book value of the stock increased from less than $60 per share in 1921 to $212 in 1941 and $234 in 1942. Taxpayer's plant and equipment were modern, up-to-date improvements being financed from earnings. During the taxable years and for many years

prior thereto taxpayer operated on a 24-hour and 7-day week basis, and had an average of from 350 to 375 employees. The three Meyer brothers had no executive assistants and worked long hours, taking no vacations in the taxable years nor, with one exception, in the previous 10 to 15 years. (R. 157a–158a.) The net sales, the net income before executives' compensation and federal taxes, the total salaries paid the three Meyer brothers, the earned surplus, and the cash dividends, during the 10-year period from 1933 through 1942 were as follows (R. 159a):

Year	Net sales	Net income before executive salaries and Federal taxes	Total executive salaries	Earned surplus	Cash dividend paid
1933	$673,751.63	$93,259.45	$27,900.00	$386,805.45	4.50
1934	692,414.69	36,011.25	20,925.00	394,544.74	0.00
1935	1,099,892.20	31,614.78	27,900.00	395,067.72	1.00
1936	1,374,909.55	133,392.57	27,900.00	468,939.85	4.00
1937	1,908,865.07	319,009.42	31,000.00	588,103.42	12.47
1938	1,622,277.34	104,627.55	37,750.00	616,281.11	1.00
1939	1,912,698.81	209,953.39	37,000.00	764,850.18	2.25
1940	2,008,039.56	179,977.75	37,000.00	858,252.81	4.00
1941	2,416,310.93	249,643.24	67,000.00	950,361.84	8.00
1942	2,700,910.21	447,533.62	127,479.85	983,012.09	8.00

The increase in sales for 1942 was due to higher prices and the increased war demand for taxpayer's products. (R. 163a.)

For the fiscal year ending September 30, 1941, the annual salaries of the Meyer brothers had been fixed at $14,000 for Samuel, $12,000 for George, and $11,000 for Albert. At a meeting of taxpayer's board of directors held August 20, 1941, it was resolved that additional compensation of

$10,000 be paid to each of the Meyer brothers; this resolution was unanimously adopted and was ratified at a stockholders' meeting held November 19, 1941. At a subsequent meeting of the board of directors, held February 4, 1942, it was resolved that for the fiscal year ending September 30, 1942, the annual compensation of the Meyer brothers should be $24,000 for Samuel, $22,000 for George, and $21,000 for Albert; and that, in addition to these fixed sums, each was to be paid, on or before November 15, 1942, 7½% of the net profits of the company for that fiscal year computed after deducting the sum of $45,000 but before deducting income taxes and the percentage of net profits to be paid to them. Each of the Meyer brothers refrained from voting upon his own compensation, and the resolutions were ratified at a stockholders' meeting on November 18, 1942. Later in the year 7½% of the company's net profits based on a certain formula was set aside for payment of bonuses to key employees. (R. 159a–161a.)

In its 1941 and 1942 tax returns taxpayer deducted $67,000 and $127,479.85, respectively, as compensation paid to the three Meyer brothers. The Commissioner determined that not more than $37,000 constituted reasonable compensation in each year, and disallowed deduction of the excess. (R. 6a–7a, 163a–164a.) The Tax Court found that $67,000 constituted reasonable compensation in each year (R. 161a); accordingly it overruled

the Commissioner's determination *in toto* as to the year 1941 and sustained it in part as to the year 1942 (R. 161a–165a.). Taxpayer appealed from that portion of the Tax Court's decision which partially sustained the Commissioner's determination for 1942. (R. 166a.) The Circuit Court of Appeals affirmed per curiam without an opinion. (R. 167.)

ARGUMENT

1. Whether a salary payment is "reasonable," and hence deductible as an "ordinary and necessary" business expense under Code Section 23 (a) (1) (A) and the long-standing applicable Treasury Regulations (Appendix, *infra*), presents a pure question of ultimate fact. Taxpayer had the burden of proving that the claimed deduction was reasonable in amount (*Botany Mills* v. *United States,* 278 U. S. 282, 289), and the Tax Court's finding of the amount constituting reasonable compensation is entitled to finality on appeal if supported by substantial evidence (*Commissioner* v. *Flowers,* 326 U. S. 465, 470; *McDonald* v. *Commissioner,* 323 U. S. 57, 64–65; *Commissioner* v. *Heininger,* 320 U. S. 467–475; *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, 370; *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C. C. A. 2d), certiorari denied, 311 U. S. 680).

The record unquestionably warrants the Tax Courts finding (R. 161, 163) that $67,000 represented reasonable compensation for the services

of taxpayer's three executive officers—the Meyer brothers—during its 1942 fiscal year. As is plain from its opinion, the Tax Court weighed all the relevant factors, those favorable to taxpayer as well as those unfavorable. The compensation of the three Meyer brothers had just been increased from \$37,000 in 1940 to \$67,000 in 1941, an increase of over 80%. (R. 159a.) The Tax Court, overruling the Commissioner's determination that only \$37,000 was reasonable, concluded that this increase was justified by the nature of their services and allowed the full \$67,000 claimed for 1941. (R. 163a.) For 1942, the taxable year here involved, taxpayer claimed a deduction of \$127,479.85 as compensation to the Meyer brothers, of which \$67,000 represented fixed salaries and \$60,479.85 represented 22½% of its 1942 net profits (7½% to each brother). (R. 160a–161a, 163a–164a.) It is this *further* increase in compensation—an increase of about 90% over the 1941 compensation of \$67,000—which the Tax Court concluded was excessive. (R. 163a–165a.) The court pointed out (R. 163a), and taxpayer does not deny, that the only fact adduced to justify deduction of such a substantial percentage of taxpayer's net profits as compensation to the Meyer brothers—in addition to their already increased fixed salaries—was an increase in its net sales for that year. This factor, while relevant, is by no means conclusive of the reasonableness of the compensation paid (*Clinton Co.* v.

Commissioner, 159 F. 2d 102 (C. C. A. 7th); *Long Island Drug Co.* v. *Commissioner, supra*); especially where, as here (R. 163a), the increase in sales was not attributable to increased services but to the war demand and higher prices for taxpayer's goods (cf. *Miller Mfg. Co.* v. *Commissioner,* 149 F. 2d 421, 423 (C. C. A. 4th)). Moreover, as the Tax Court further noted (R. 164a), the additional compensation for 1942 was measured by a percentage of taxpayer's net profits; provided for the same percentage (7½%) to each of the Meyer brothers, although their fixed salaries differed; and was not awarded before their services were rendered, but after operational results for the first quarter were known. See Section 19.23 (a)–6 (2) of Treasury Regulations 103 (Appendix, *infra*). What is more, the compensation was not fixed by an arms length bargain; the Meyer brothers were the controlling stockholders and directors of taxpayer (R. 158a, 162a),[3] an important factor to be considered. *Crescent Bed Co.* v. *Commissioner,* 133 F. 2d 424 (C. C. A. 5th). Nor was any competent proof

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[3] The Tax Court found (R. 158a, 162a), and it is not disputed, that the Meyer family owned 3,432 of the 6,000 outstanding shares of taxpayer; that a voting trust of which the Meyer brothers were voting trustees held 51% of the shares; and that three of the seven directors were the Meyer brothers themselves, while two of the other directors (Murphy and Heinl) were employees who had deposited their stock in the voting trust and shared in a bonus awarded at the same time that the additional compensation to the Meyer brothers was awarded.

offered by taxpayer to afford a comparison of the compensation it paid the Meyer brothers with that paid "for like services by like enterprises under like circumstances". Section 19.23 (a)-6 (3) of Treasury Regulations 103 (Appendix, *infra*); *Clinton Co.* v. *Commissioner, supra.* As the Tax Court observed (R. 162a), taxpayer's so-called expert witnesses were not qualified to express an expert opinion; and even assuming they qualified, the Tax Court would not have been bound by their opinion. *In re Rae's Estate,* 147 F. 2d 204 (C. C. A. 3d); *L. & C. Mayers Co.* v. *Commissioner,* 131 F. 2d 309 (C. C. A. 2d), certiorari denied, 318 U. S. 773.

Under the circumstances the Tax Court was fully justified in concluding that taxpayer failed to meet its burden of proving that the amount of $127,479.85 it deducted for 1942 represented reasonable compensation. Indeed, the Tax Court was more than liberal in overruling the Commissioner's determination that $37,000 was reasonable, and in allowing $67,000 instead. Under familiar rules governing the scope of judicial review of the Tax Court's factual determinations, affirmance of its decision by the court below was clearly correct.

2. Taxpayer's elaborate discussion (Pet. 4–25) of the scope of appellate review of Tax Court decisions is academic. For even assuming, *arguendo,* that the Administrative Procedure Act, c. 324, 60 Stat. 237, applies to the Tax Court

and also that it "enlarges" the scope of review of its decisions,[4] affirmance of the Tax Court's decision by the court below was correct. Taxpayer's argument reduces itself, in terms of this case, simply to the contention (Pet. 3, 20–24) that the court below was precluded from affirming the Tax Court's decision because "no finding" was made as to the reasonableness of the claimed salary deduction for 1942. To so contend, however, is to disregard the plain tenor of the Tax Court's findings and opinion.[5] The

[4] The standards prescribed in Section 10 of the Administrative Procedure Act for review of administrative agency actions are essentially the same as those prescribed in Section 1141 (c) of the Internal Revenue Code for review of Tax Court decisions. The so-called "substantial evidence" rule embodied in Section 10 (e) (B) (5) of that Act has long been applied upon review of Tax Court decisions. See, e. g., *Helvering* v. *Rankin*, 295 U. S. 123, 131; *Wilmington Co.* v. *Helvering*, 316 U. S. 164, 168; *Dobson* v. *Commissioner*, 320 U. S. 489. Besides, the legislative history of the Act indicates that it was not intended to alter existing rules governing the review of factual determinations by administrative agencies. The original draft of Section 10, prepared by the American Bar Association Committee on Administrative Law, carried the comment that its provisions were not intended to expand the scope of judicial review. 30 A. B. A. J. 46. See also, to the same effect, the statements by Senator McCarran, Chairman of the Senate Judiciary Committee, explaining the bill on the floor of the Senate. 92 Cong. Record, Part 2, pp. 2157–2159 (S. Doc. No. 248, 79th Cong., 2d Sess., pp. 321–322). And see Representative Hobbs' extension of remarks, 92 Cong. Record, p. A2987 (S. Doc. No. 248, *supra*, p. 415).

[5] At the outset of its opinion (R. 157a) the Tax Court stated that "The only issue submitted is the reasonableness of the compensation paid" for the two taxable years in-

basic and only issue before the Tax Court was whether the $127,479.85 claimed by taxpayer, or the $37,000 allowed by the Commissioner, or some in-between figure, represented a "reasonable" allowance; it properly addressed itself to that issue and found that $67,000 was reasonable. And the only question before the court below was whether that finding of ultimate fact was supported by substantial evidence. The evidentiary facts dispositive of this case are undisputed and, we submit, they support the Tax Court's decision "under any theory of judicial review". *Ander-*

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volved. After reviewing the evidence, it found (R. 161a, 163a–164a) that $67,000 was "reasonable" for each year. Taxpayer's insistence (Pet. 21, 23) that the Tax Court made no finding that $67,000 was reasonable for 1942 because it did not preface that figure with the word "only" is sheer quibbling. Indeed, taxpayer acquiesced in the Commissioner's proposed computation of the 1942 deficiency based on the Tax Court's allowance of $67,000. (R. 165a.)

Equally untenable is taxpayer's assertion (Pet. 3, 19, 20) that the Tax Court predicated its decision solely on the ground that the payment in excess of $67,000 represented a dividend distribution rather than compensation. True, in answer to taxpayer's contention below that it was not a dividend, the Tax Court in the concluding portion of its opinion (R. 164a) stated that taxpayer had not sustained the burden of proving that contention; but this was patently a cumulative ground for its decision. Nor is there any basis for taxpayer's corollary supposition (Pet. 19) that a distribution of corporate earnings which represents "compensation" rather than a dividend must be deemed a deductible business expense; to qualify for deduction under Section 23 (a) (1) (A) and the pertinent Regulations the "compensation" must be "reasonable." See *Long Island Drug Co.* v. *Commissioner*, *supra*, pp. 594–595.

son v. *Commissioner* (C. C. A. 7th), decided December 17, 1947 (1948 C. C. H., par. 9109); *Credit Bureau of Greater N. Y.* v. *Commissioner,* 162 F. 2d 7, 9 (C. C. A. 2d); *Dawson* v. *Commissioner,* 163 F. 2d 664, 667 (C. C. A. 6th).

3. Taxpayer does not and cannot allege conflict with any other decision. Its assertion (Pet. 20) of "probable conflict" with *Securities Comm'n* v. *Chenery Corp.,* 332 U. S. 194, and like decisions, rests entirely upon its gratuitous assumption that the Tax Court made "no findings" respecting the reasonableness of the claimed salary deduction. Far from precluding affirmance of the Tax Court's decision, the *Chenery* case demands it. This Court there held (p. 207) that upon review of an administrative agency action the appellate court's "duty is at an end" if the administrative action is "based upon substantial evidence" and does not lack a "rational and statutory foundation". Certainly its duty upon review of Tax Court decisions is no greater, for "every reason ever advanced in support of administrative finality applies to the Tax Court". *Dobson* v. *Commissioner,* 320 U. S. 489, 498.

CONCLUSION

There is no occasion for further review. This case presents a pure question of fact. Neither an important question nor a conflict is involved. The petition should therefore be denied.

Respectfully submitted.

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FEBRUARY 1948.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:

(a) [As amended by Section 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * (26 U. S. C. 1940 ed., Sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (a)-6. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend

on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than

the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

* * * * *

Sec. 19.23 (a)–8. *Bonuses to employees.*—Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

U. S. GOVERNMENT PRINTING OFFICE: 1946